BEFORE THE INSURANCE COMMISSIONER
OF THE STATE OF WASHINGTON

In the Matter of the Application regarding the Conversion and Acquisition of Control of Premera Blue Cross and its Affiliates,	Docket No. G02-45 ALASKA INTERVENORS' POST-HEARING BRIEF ON ALLOCATION ISSUES

The Alaska Intervenors hereby file this post-hearing brief on the issue of fair allocation of Premera's assets between Washington and Alaska and the related question of whether the outstanding allocation issues prevents the Commissioner from determining that the conversion is in the public interest, thereby necessitating a disapproval of the proposed conversion.

ARGUMENT

I. The Outstanding Allocation Issue Requires Denial of Premera's Request for Conversion in its Current Form.

Under the Holding Company Acts, specifically RCW 48.31C.030, the Commissioner must consider whether the conversion is in the public interest. In considering the public interest, he must decide whether the fair value of Premera's assets have been set aside for the citizens of

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Washington. *See Fourth Order: Ruling on Motions to Intervene* at 4. The Commissioner cannot properly consider this issue because Premera's value is unknown. As is the allocation of Premera's assets among Washington, Alaska, and Oregon yet unknown.[1] Thus, and in short, whether the fair value of Premera's assets will be set aside upon conversion to immediately fund either the Washington or Alaska foundations is unknown.

What is known is that not all of Premera's assets will inure to the proposed foundations and that those foundations will not be independent of Premera. Given the uncontrollable negative impacts that flow from the proposed conversion, as articulated in great detail in the Washington Intervenors' Post-Hearing Brief, the public interest requires that the foundations receive the full value of Premera's assets and be sufficiently independent of Premera simply to mitigate against the guaranteed negative impacts. Given the facts before him, the Commissioner cannot find that the conversion, as structured, is in the public interest.

II. The Record Before The Commissioner Does Not Support the OIC Staff Consultants' Allocation Recommendation for Washington.

There is insufficient evidence in the record before the Commissioner to support a determination that 85 percent of Premera's assets should be allocated to Washington, as has been recommended by the OIC Staff's Consultants PriceWaterHouseCoopers (PwC) and The Blackstone Group (Blackstone). As demonstrated below, there are several flaws in the OIC

[1] The Attorney General of Oregon has asserted a claim for a portion of Premera's assets. Cantilo & Bennett have advised that this claim lacks merit. *See Hearing Exhibit S-35* (Letter of 1/16/04). Whether this claim has any merit is a determination that should be made before the conversion is approved because once a conversion has been approved; the Commissioner will not be able to unring the bell if it is later determined that Alaska's or even Oregon's shares of Premera's assets are greater than what has been recommended by the OIC Staff's consultants.

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Staff's consultants' analyses that prevent the Commissioner from approving an allocation of 85 percent to Washington and only 15 percent to Alaska.

A. PwC's Actuarial Analysis

The Washington consultants, PwC, and the Alaska consultants, Reden & Anders, took the same basic methodological approach to analyzing the appropriate allocation of Premera's assets for Washington and Alaska. They both considered what each state has contributed historically and prospectively to arrive at an appropriate range of allocation for each state.[2] Where they primarily differ is that, unlike Reden & Anders, PwC took a much more creative tact and added qualitative factors (or what PwC deems "additional considerations") to its contribution analysis, each of which, not surprisingly, favor Washington. These additional considerations make up for 1 – 6 percent of PwC's recommended allocation range. Thus, if PwC's recommended range was to be unbundled and the "additional considerations" removed, the most that could be awarded to Washington is 81-82 percent, not 85 percent.[3] Staehlin Testimony Tr. 1917:19-20.

1. **PwC's Assertion that Alaska Should be Charged an IPO Participation Fee is Nonsensical.**

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[2] Within their respective historical and future contribution analyses, there are substantial differences. For example, each state's consultants weighed certain factors differently. For instance, PwC adjusted the 1997 – 2002 actual allocation of expenses data that it received from Premera to comport with adjustments that it had made to previous and future years' data. While both Reden & Andersa and PwC made adjustments to previous years because, in part, actual data for certain years was missing, PwC did not demonstrate how actual audited data from 1997-2002 should be adjusted without any concrete evidence that the actual data supplied was wrong.

[3] The Alaska Intervenors do not concede that Washington is entitled to 81-82%. As detailed in *Statement of the Alaska Division of Insurance Regarding Proposed Conversion of Premera* (Statement of ADI) and *Additional Statement of the Alaska Division of Insurance Regarding Proposed Conversion of Premera* (Additional Statement of ADI), Mar. 28, 2004, (incorporated by reference herein and attached hereto) there are other flaws in PwC's and Blackstone's findings that further lessen their total recommendation amount.

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Somewhat belatedly, PwC determined that Alaska should have to pay for the benefit it receives for participating in a *joint* IPO with Washington.[4] *See Actuarial Analysis of the Proposed conversion of Premera Blue Cross for the State of Washington* (PwC Report), Mar. 26, 2004, at 22, 26. This determination, however, suffers from a number of flaws. First, there is no joint IPO contemplated. There is only *one* IPO; and that is of the entire holding company, not of separate divisions or lines of business. Staehlin Testimony Tr. 1928:23-25; 1929:1-3. Even if it were theoretically appropriate to charge Alaska for participation in an IPO of the holding company, there is no support in the record for a $5 million charge as assessed by PwC. Indeed, as neither Blackstone nor PwC has been able to explain precisely what the overall cost of the IPO will be, it is unclear how PwC arrived at this $5 million figure.[5] Staehlin Testimony Tr. 1930:7-8; Koplovitz Testimony Tr. 1423: 14-21. PwC's report certainly does not explain it.

PwC also asserts that this IPO participation fee is worth 0 – 2 percent of the total value of Premera. *PwC Report* at 26. The total value of Premera, however, remains a mystery: none of the states' consultants have conducted a formal valuation analysis of Premera's worth. What it unclear is what happens to this percentage if the total value changes before the IPO occurs: PwC's report does not indicate whether this 0-2 percent range is a fixed number or a true percentage. It is thus unfathomable how PwC determined with accuracy that this IPO participation fee is worth approximately $5 million dollars and worth anywhere from zero to

[4] PwC's preliminary report of February 2004 does not include an IPO participation fee, yet the recommended range is the same in both the preliminary and final reports. See, generally, PwC Report and Hearing Exhibit S-23.

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two percent of Premera's total value.[6] The Alaska Intervenors submit that the starting point of PwC's percentage range for this fee -- zero percent -- is the appropriate worth for this factor. The IPO participation fee is arbitrary, artificially boosts the range of value for Washington, and is not, in the final analysis, supported by any credible evidence.

2. Requirement for Capital and Allocation of Start-Up Expenses for Alaska is Not Supported by Hard Evidence.

Under PwC's analysis, Alaska would have required capital to support its operations in the start-up years. *PwC Report* at 25. PwC then applies today's Risk Based Capital (RBC) requirements as a benchmark to the start-up of some fifty years ago and concludes that Alaska would have required a loan of up to $10 million for capital. *See id.* According to PwC, this theoretical loan must have come from Washington. PwC's analysis ignores, however, the fact that the Alaska operations were simply an extension of Premera's Washington business and no separate RBC was ever required for Alaska. *See Statement of ADI* at 16. PwC's report as well as its response to the Statement of ADI have failed to identify any capital that the Alaska operations did not contribute, thereby negating the assumed "loan" from Washington.

Further compounding this "loan for capital" assumption is PwC's adjustment to historical expenses for the amount it claims Premera would have incurred to start its operations in Alaska. *See PwC Report* at 16-17. PwC's adjustment increased Alaska's historical expenses by $1.5 million for the period 1953-1973. *Statement of ADI* at 10. To make such a speculative

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[5] PwC's report also fails to disclose whether other subsidiaries are being charged to participate in the IPO for the holding company and whether the costs are being divided equally among the divisions or lines of business.
[6] Interestingly, this factor appears to be an investment banking consideration, but was not included in Blackstone's report.

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adjustment, PwC ignored several key facts. First, Premera's start-up in Alaska was not realized via creation of a subsidiary, but through an extension of Premera's existing Washington operations. *See id.* Second, administrative services were already in place in Washington. *See id.* Third, and importantly, PwC found no concrete evidence in all the data that it reviewed (nor presumably through the interviews that it conducted with Premera's management) to support its assumption that such expenses were required to "reflect the true value of cost of doing business in Washington and Alaska at that time". Staehlin Testimony Tr. 1885: 12-14. And, as Mr. Staehlin conceded during the hearing, if Premera had received contributions from external sources, this might explain why such expenses had not been allocated on its books. Staehlin Testimony Tr. 1921: 22.

Assuming that it is appropriate for an actuary to consider loans from one state to another to determine appropriate contribution then, logically, it would be appropriate to consider loans from Alaska to Washington, not just from Washington to Alaska. Yet, PwC failed to do so. Noticeably absent from PwC's response to the Statement of ADI is any defense of why it considered a loan from Washington to Alaska for start-up from 1953-1973 but did not consider a loan from Alaska to Washington during the 1980's and 1990's when Premera's Washington operations were experiencing substantial financial difficulties, but the Alaska operations were not.[7]

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[7] The record reflects that Premera's Washington operations suffered operating income losses during this time period. "[C]umulative operating income was 100/00 Alaska/Washington in the lates 1980's when Washington was experiencing financial difficulties….In addition, in numerous years during the 1990's, the Alaska operations contributed over 100% of PBC's net income." *Statement of ADI* at 16-17. And, the "Alaska operations provided the

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B. Blackstone's Analysis

Blackstone has opined, from an investment banking perspective, that the appropriate allocation of proceeds between Washington and Alaska is 83-89 percent for Washington and 17 – 11 percent for Alaska. *See Updated Discussion Materials: Allocation between Washington and Alaska, The Blackstone Group* (Blackstone Report), Mar. 30, 2004, at 1, (Hearing Exhibit S-6). As evidenced by the record before the Commissioner, the *Statement of ADI*, and *Additional Statement of ADI*, Blackstone's analysis suffers from a number of serious errors, such as ignoring critical facts that would reduce its allocation recommendation for Washington.

Rather than reiterate those points here, the Alaska Intervenors will simply address the following regarding Blackstone's report: An unknown portion of Blackstone's final allocation range is premised on the assumption that certain metrics, net income and operating income, are less reliable indicators of value because they include allocation of fixed costs. *SeeBlackstone Report* at 1. Therefore, Blackstone placed greater emphasis on other metrics than did Signal Hill Capital, the investment banking consultants retained by the Alaska Division of Insurance. Blackstone's conclusions in this regard rest not on its own assessment of the appropriate allocation of expenses, but on PwC's assessments of the allocation of expenses. Koplovitz Testimony Tr. 1425: 9-12. Indeed, Mr. Koplovitz testified that,

> …maybe Blackstone doesn't even have a point of view on that – but our actuaries kind of advised us that some of these allocations didn't make sense. So we put

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only non-profit book net income in 1997 as well as 42.6% and 39.5%, respectively, of the net book income in 1998 and 1999." *Id.* at 28.

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less emphasis on operating profit and net profit because these included these allocations which, to our actuaries, you know didn't make sense.

Id. at 1381:2-7. Blackstone's "expert" conclusions are therefore premised on assumptions that it cannot explain or defend. Assumptions that, as explained in great detail in the Statement of ADI, are flawed. *See generally Statement of ADI, 26-27.* The Commissioner should, therefore, accord no weight to Blackstone's conclusions on the reliability of net income and operating income metrics for purposing of determining appropriate allocation between Washington and Alaska.

CONCLUSION

For the reasons set forth above, due to the outstanding allocation issues, the Commissioner should disapprove the conversion. Alternatively, the Commissioner cannot find on the record before him that 85 percent of Premera's assets should be allocated to Washington.

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Dated this 28th day of May, 2004.

Respectfully submitted by:

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